NO. 31 1

IN THE

Supreme Court of the United States

October Term, 1966

J. E. DAVANT AND KATHRYN DAVANT, ET AL.,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioners, J. E. Davant and Kathryn Davant, Hortense E. Davant, T. E. Dunnam and Mary Anne D. Dunnam, Estate of L. D. Clements, deceased, Ruth Neal Clements, Executrix, and Mrs. L. D. Clements, individually, William S. Fly and Betty Clements Fly, S. M. Clements and Mrs. S. M. Clements, Edward W. Clark and Marienne Clements Clark, Raye W. Pegram, R. Q. Pegram and Mrs. R. Q. (Denny) Pegram, Scranton B. Jones and Joyce Pegram Jones, Jack R. Dodson and Kathryn D. Dodson, and William G. Elliott and Peggy Pegram Elliott, pray that a writ

of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above entitled case (No. 22,835 below), affirming that part of the judgment of the Tax Court of the United States adverse to petitioners and reversing that part of the judgment of the Tax Court in favor of petitioners.

CITATION TO OPINIONS BELOW

The opinion of the Tax Court (R. Vol. I, 184-254), is reported in 43 T.C. 540. The opinion of the Court of Appeals (R. Vol. III, 622-654, *infra*, Appendix A, p. 27).

JURISDICTION

The judgment of the Court of Appeals, affirming that part of the judgment of the Tax Court of the United States adverse to petitioners and reversing that part of the judgment of the Tax Court in favor of petitioners, was entered on August 22, 1966 (R. Vol. III, 656, *infra*, Appendix A, p. 58). On September 12, 1966 petitioners filed their Motion for Rehearing (R. Vol. III, 657-661). Nine copies of that Motion are filed with the Court herewith. The order of the Court of Appeals denying the Motion for Rehearing was entered on October 4, 1966 (R. Vol. III 297, *infra*, Appendix A, p. 58). Jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

STATEMENT CONCERNING THE RECORD

As the record in this case is out of the ordinary, we pray the indulgence of the Court in a short explanatory statement. About 1933 five families, Davant, Woods, Savage, Pegram, and L. D. Clements, formed South Texas Water Company, herein called "Water Company," to run an irrigation system for rice growing around Rosharon in south Texas. In 1934, L. D. Clements' brother, S. M. Cle-

ments, incorporated South Texas Warehouse Co. (herein called Warehouse Company), as its sole owner, and had it build at Rosharon a warehouse for storing rice. In 1939 S. M. Clements bought the stock of Woods in the Water Company and sold to the others stock in the Warehouse Company. Several years prior to July 1, 1957, Savage died, and the other four families bought his interest in both companies and since that time both have been owned by the Davant, Pegram, L. D. Clements and S. M. Clements families in equal proportions. In the late 1940s when rice driers were perfected Warehouse Company installed such a drier.

In 1957 the Davant and Pegram families and the children of L. D. and S. M. Clements formed a partnership, South Texas Enterprises, herein called "Enterprises," in which the Davant and Pegram families each owned 25% and the children of L. D. Clements and S. M. Clements each owned 25%, the two elder Clements not being in the partnership. The Warehouse Company then leased its properties to Enterprises effective July 1, 1957, for a rental of $48,000.00 a year. The Government asserted that under Sec. 482 of the Internal Revenue Code the rental should be $78,000 a year and that was the question involved in the Warehouse Company case, No. 22,834 below.

Three years later, in 1960, the stockholders of Warehouse Company sold all their stock to another individual. He had the Warehouse Company adopt a plan of liquidation under sec. 337 of the Internal Revenue Code, and had the Warehouse Company sell all of its assets, except cash, to the Water Company for $700,000 in cash and the assumption of any liabilities of Warehouse Company. The Government refused to recognize that sale of the stock to the individual, and asserted that there was a reorganization

between the Warehouse Company and the Water Company under sec. 368(a) (1) (D) of the Internal Revenue Code and also under sec. 368(a)(1)(F) of the Code, and that the stockholders of the Water Company received the $700,000 paid by the Water Company and the other cash which Warehouse Company owned and distributed, all as dividends from both the Warehouse Company and the Water Company. These latter contentions of the Government were litigated in the present case, known as the "Davant case," No. 22,835 below.

Thus the two cases involve entirely separate matters. However, to avoid a duplication in the presentation of evidence, the Tax Court ordered that the Warehouse Company's case be tried first and that the evidence taken therein should be considered as evidence in the individual Davant case. We quote the following from the proceedings of the Tax Court (R. Vol. I, 22):

"The Court:

> The stipulation is now we will try the warehouse case with the stipulation that all evidence taken in the warehouse case will be evidence in the individual cases, but that we will proceed then to try the individual cases for what further evidence is needed."

In the Court of Appeals, the Court entered an order reading in part as follows (R. Vol. I, 2):

> "(2) The minutes of the proceedings before the Tax Court on April 23, 1964, covering the proceedings in No. 22834 and the Findings of Fact and Opinion of the Tax Court therein shall be printed in the printed record only in No. 22834, but pursuant to the stipulation may be considered by the Court as part of the record in No. 22835."

In the Court of Appeals for the Fifth Circuit the Warehouse case was No. 22,834 and the Davant case was No. 22,835. The taxpayers in both cases are filing simultaneously their petitions to this Court for writs of certiorari. There are being filed with this Court in the Warehouse case nine copies of the printed record in No. 22,834 below in addition to the certified copy of the proceedings below. In the Davant case the petitioners are filing one printed copy marked Volume I of the record below in the Warehouse case, one printed copy marked Volume II of the record below in the Davant case, and one copy marked Volume III which is certified to by the Clerk below as containing the proceedings in the Court of Appeals in the Davant case. The clerk further certifies that these Volumes I, II and III constitute the entire record in the Davant case.

In the Davant case these petitioners are filing nine copies of the printed record set out in Volume II. That Volume II consists of the printed record on the appeal of the petitioners and the supplemental printed record on the appeal of the Commissioner, and in the nine copies we are filing with the Court we have marked the supplemental printed record Volume II A. However, we are not filing additional copies of Volume I, being the printed record in the Warehouse case, as they are not available. We ask the Court, therefore, to consi er the nine copies of the printed record filed in the Warehouse case as part of the record in this case.

The Tax Court handed down one consolidated opinion, set forth in the Warehouse record at Volume I, pages 184 to 255. As that opinion is set forth therein and is seventy-two pages in length, we are not printing a copy of that opinion as an appendix to our petitions for certiorari in either case, and pray the Court to refer to it in the printed record in the Warehouse case.

QUESTIONS PRESENTED

In discussing the questions presented we will assume at first that the sale of the Warehouse stock is to be ignored and that the stockholders of the Water Company continued to be the stockholders of the Warehouse Company. Later we will challenge the lower Courts' ignoring that sale.

This petition presents the following important questions:

1. Where the Water Company and the Warehouse Company had been entirely separately operated companies since about 1934, could the purchase by the Water Company of the assets of the Warehouse Company in 1960 be a reorganization under sec. 368(a)(1)(F) of the Code? The holding of the Court of Appeals is in direct conflict with this Court's decision in *Helvering v. Southwest Consolidated Corporation,* 315 U.S. 194, and the holdings in *Moline Properties, Inc. v. C.I.R.,* 319 U.S. 436 and *National Carbide Corporation v. C.I.R.,* 336 U.S. 422, that the separate existence of corporations may not be ignored.

2. Could the purchase by the Water Company of the assets of the Warehouse Company in 1960 be a reorganization under sec. 368(a)(1)(D) of the Code? The holding of the Court of Appeals that there was is directly contrary to the wording and meaning of sec. 368(a)(1)(D) and the holdings in *Cortlandt Specialty Co. v. C.I.R.,* 60 F.2d 937 (2 CCA) and *Pinellas Ice & Cold Storage Co. v. C.I.R.,* 287 U.S. 462.

3. If we assume that there was a reorganization under sec. 368(a)(1)(D) or (F), could there be a dividend to the stockholders from the Water Company? The holding of the Court of Appeals that there was is directly contrary to the plain wording and meaning of sec. 356 of the Code and is in direct conflict with this Court's decision in *Com-*

missioner v. Palmer, 302 U.S. 63, and the decisions in *Southern Ford Tractor,* 29 T.C. 833; *Rodman Wanamaker Trust,* 11 T.C. 365, affirmed 178 F.2d 10 (3 CCA); *Emma Cramer,* 20 T.C. 679 (Acq. 1960-1 C.B. 4); *Trianon Hotel Company,* 3 T.C. 156; and *C.I.R. v. Pope,* 239 F.2d 881 (1 CCA).

4. If the transactions here involved were not a reorganization under sec. 368(a)(1)(D) or (F) of the Code, was the holding of the Court of Appeals that the stockholders received a dividend from the Water Company correct? Such a holding is in direct conflict with *Rodman Wanamaker Trust,* 11 T.C. 365, *Emma Cramer,* 20 T.C. 679, and *Trianon Hotel Company,* 30 T.C. 156, and the refusal by Congress in the Revenue Act of 1950 and in the Internal Revenue Code of 1954 and later Revenue Acts to provide that the purchase of the assets of one corporation by a commonly controlled corporation would be a dividend.

5. May the Court of Appeals completely ignore everything that was done and hold that there were three independent transactions: (a) $700,000 of earnings of Water Company were passed through Warehouse Company to petitioners; (b) $200,000 of earnings of Warehouse Company were distributed to petitioners; and (c) the operating assets of Warehouse Company were then owned by Water Company? Such a holding is in direct conflict with this Court's holdings in *Gregory v. Helvering,* 293 U.S. 465, and in many other cases that taxpayers may arrange their transactions in such manner as will reduce their income tax liability.

6. May the Court of Appeals hold that, since petitioners could have had the Warehouse Company transfer its assets including its cash to the Water Company without paying

any tax and without the Water Company paying $700,000 for the Warehouse Company assets and without the Warehouse Company distributing the $700,000 and its own $200,000, petitioners should be held to have received the $900,000 as dividends? Such a holding is directly contrary to the holdings of this Court in *Commissioner v. Brown,* 380 U.S. 563; *Old Colony Railroad Co. u. C.I.R.,* 284 U.S. 552; *Helvering v. Hammel,* 311 U.S. 504; *Helvering v. Flaccus Leather Co.,* 313 U.S. 247; *Hanover Bank v. C.I.R.,* 369 U.S. 672; and *Turnbow v. C.I.R.,* 368 U.S. 337, and many other cases that the Internal Revenue Code must be given effect as written.

7. Where petitioners sold their stock in the Warehouse Company to a third individual for over $900,000 with no contract or commitment on his part as to what he would do, may the Court of Appeals completely ignore that sale and treat petitioners as continuing to own the stock of Warehouse Company through all these transactions? Such a holding is in conflict with the decisions in *Commissioner v. Brown,* 380 U.S. 563; *W. P. Hobby,* 2 T.C. 980; *Sun Properties, Inc. v. United States,* 220 F.2d 171 (5 CCA); and many other cases.

STATUTES INVOLVED

The applicable statutes are sections 301(a) and (c), 302(a) and (b)(1), 304(a), 316(a), 337(a), 354(a) and (b), 356(a) and (b), 368(a)(1) and 1201(b) of the Internal Revenue Code. They are set forth in Appendix B hereto. In Appendix C we set forth briefly the history of the definition of a reorganization.

STATEMENT

In August 1960 some of the stockholders wanted to have the Warehouse Company sell its properties to the Water

Company at their fair market value which they believed, and which the Tax Court found, to be $700,000. As shown by the testimony of the undersigned, Homer L. Bruce (R.Vol.II, 37-43), he advised them as their attorney that, if the Warehouse Company adopted a plan of liquidation under section 337 and sold the properties to the Water Company, there would be no tax on the Warehouse Company and the stockholders on the liquidation of the Warehouse Company would have a long term capital gain. He advised, however, that revenue agents were trying to bring such transactions within the definition of reorganizations under sec. 368(a)(1)(E) and (F) and hold they were dividends under sec. 356, and further that some revenue agent might come in and say in spite of the specific provisions of section 304 that they had gotten a $700,000 dividend from the Water Company. He advised them that under the decisions in *W. P. Hobby*, 2 T.C. 980, and *Sun Properties, Inc.*, 220 F.2d 171, and other cases, if they would make a bona fide sale of their stock, the new stockholder could have the Warehouse Company liquidated and sell its properties to the Water Company and that they would pay a capital gains tax on their profit on the sale of the stock. He testified that S. M. Clements said that he knew Homer L. Bruce, Jr. for about twelve years and suggested that the sale be made to him. It was understood that Homer L. Bruce, Jr. would make a profit of approximately $15,000 (R.Vol.II, 41-123).

J. E. Davant testified that he was a lawyer and was afraid an agent might raise up the very questions they are raising in this case and he would not have had this transaction except through this sale to Homer L. Bruce, Jr. (R.Vol.II, 46-49). William S. Fly was also a lawyer and

testified that he relied on Davant's advice and decided to go the route of the sale to Homer L. Bruce, Jr.

On August 26, 1960, Homer L. Bruce, Jr. borrowed from Bank of the Southwest of Houston, Texas, $914,200, which was deposited to his credit in that Bank. He thereupon bought all the stock of the Warehouse Company from the stockholders and gave them his checks totaling $914,200 on the Bank of the Southwest which they deposited in their own accounts in their own banks and which were later paid by the Bank of the Southwest (R.Vol.II, 63-66, Exhibit 13). On the same day he had the stock of the Warehouse Company transferred into his name, had himself and his own men elected president and officers and directors, and as the sole stockholder had the Warehouse Company adopt a plan of liquidation under section 337. On the same day the Warehouse Company sold all of its properties to the Water Company for $700,000 in cash and the assumption by the latter of its liabilities. This $700,000 was deposited in the Bank of the Southwest to the credit of the Warehouse Company as it already had $230,000 on deposit. The Warehouse Company then issued two checks aggregating $416.70 for certain expenses which left it having in the Bank $929,583.30. It thereupon distributed that $929,583.30 to the said Homer L. Bruce, Jr., who thereby made a profit of $15,583.30. The Warehouse Company, having given the Water Company a deed to its properties, the latter became the owner thereof (R. Vol.II, 63-74). Neither he nor the Warehouse Company had any agreement or commitment of any kind as to what he would do with the stock or what either of them would do with the properties (R.Vol.II, 74).

The Government contended that the sale to Homer L. Bruce, Jr. should be disregarded, that there was a reorgan-

ization between the two companies under sec. 368(a)(1)(D), (E) and (F), and that petitioners should be held to have received a dividend to the extent of the full $914,200 from the Warehouse Company and the Water Company.

The Tax Court disregarded the sale to Homer L. Bruce, Jr., rejected the Government's contentions that there was a reorganization under sec. 368(a)(1)(E) and (F) and that there was a dividend from the Water Company, but held there was a reorganization under sec. 368(a)(1)(D) and that petitioners received a dividend under sec. 356 equal to the accumulated earnings of the Warehouse Company but not any dividend from the Water Company.

The Government further contended that the fair value of the properties of the Warehouse Company was considerably below the $700,000 paid for them by the Water Company and any such excess should be treated as a dividend to the petitioners from the Water Company. However, the Tax Court found that on August 26, 1960, the properties of the Warehouse Company had a fair value of at least $700,000 and thus denied this position by the Government.

The petitioners appealed to the Court of Appeals from the judgment of the Tax Court adverse to them. The Commissioner filed a cross appeal appealing from the holding of the Tax Court that the petitioners did not receive the taxable dividend from the Water Company (R.Vol.II, (545-612), supplemental printed record Vol. III A, 15-66).

The Court of Appeals ignored the sale to Homer L. Bruce, Jr., held there was a reorganization under sec. 368(a)(1)(F) and sec. 368(a)(1)(D), and that the pe-

titioners received dividends from both the Warehouse Company and the Water Company, and found that, since the petitioners could have had the Warehouse Company transfer its assets to the Water Company free of any tax, they should be treated as receiving the full $700,000 and $200,000 cash as dividends. The approach of the Court of Appeals is well illustrated by the following extract from its opinion:

> "Three distinct and separate things occurred.
>
> First; $700,000 in earnings and profits possessed by Water were passed through Warehouse to petitioners. Second, $200,000 in earnings and profits from Warehouse were distributed to petitioners. Third, the operating assets of Warehouse were combined with Water and were from that point on owned and controlled through Water. Only one business nontax avoidance purpose can be found to support any of these events: petitioners wished to eliminate one of the corporate shells and thereafter control all of the properties under one roof. This motive legitimately explains why petitioners transferred the operating assets of Warehouse to Water. But it does not explain either of the first two steps. Under the reorganization provisions of the Code petitioners could have transferred all of Warehouse's assets, including its earnings and profits, to Water without paying any tax. Thus the payment of $200,000 from Warehouse to petitioners cannot be explained as necessary in order to place both businesses under the same roof. Likewise, there was no need for petitioners to cast the transfer of Warehouse's operating assets in the form of a sale. The businesses could be combined under one roof without the $700,000 from Water ever coming over to Warehouse. It is apparent that no functional relationship exists between either the $200,000 coming to petitioners from Warehouse or the $700,000 coming to petitioners from Water and the transfer of Warehouse's assets to Water."

REASONS FOR GRANTING THE WRIT

1. Contrary to the holding of the Tax Court, the Court of Appeals held that there was a reorganization of the Warehouse Company and the Water Company under sec. 368(a)(1)(F). That section defines a reorganization as

> "(E) a capitalization; or
> (F) a mere change in identity, form or place of organization, however effected."

We ask how the Court of Appeals could say that, where these two companies had been separately in existence since 1934 and the Water Company purchased the assets of the Warehouse Company for $700,000 in cash and the Warehouse Company was dissolved, there was

> "a mere change in identity, form or place of organization"?

Such a holding is directly contrary to the decisions in *Helvering v. Southwest Consolidated Corporation*, 315 U.S. 194, and *Joseph C. Gallagher*, 39 T.C. 144, construing (E) and (F), and in *Moline Properties, Inc. v. C.I.R.*, 319 U.S. 436, and *National Carbide Corporation v. C.I.R.*, 336 U.S. 422, that the separate existence of corporations may not be ignored.

2. The holding of the Tax Court and of the Court of Appeals that there was a reorganization of the Warehouse Company and the Water Company under sec. 368(a)(1)(D) is completely untenable and contrary to the wording and meaning and spirit of sec. 368(a)(1)(D).

Sec. 368(a)(1)(D) and sec. 354 referred to therein of the 1954 Code correspond to sec. 112(g) and sec. 112(b)(3) of the 1939 Code. The 1954 Code made extensive changes in those provisions and we set them out in parallel columns so that these changes may be readily apparent:

1939 Code

SEC. 112(g) DEFINITION OF REORGANIZATION.—As used in this section (other than subsection (b)(1) and subsection (1)) and in section 113 (other than subsection (a)(22)).—

(1) The term "reorganization" means * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, * * *.

SEC. 112. RECOGNITION OF GAIN OR LOSS. (b) EXCHANGES SOLELY IN KIND.—

1954 Code

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combinations thereof, is in control of the corporation to which the assets are transferred; *but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;* * * * (Emphasis added)

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(3) STOCK FOR STOCK ON REORGANIZATION. — No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are trans-

> ferred acquires substantially all of the assets of the transferor of such assets; and
>
> (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Before discussing the importance of the changes made in the 1954 Code we refer briefly to the statements by this Court and others that a mere sale by one corporation of its assets to another for cash cannot be a reorganization. One of the earliest cases was *Cortlandt Specialty Co. v. C.I.R.*, 60 F.2d 937, by Judges Augustus N. Hand, Learned Hand and Chase of the Second Circuit Court of Appeals, who said at 60 F.2d 939:

> "Reorganization, merger, and consolidation are words indicating corporate readjustments of existing interests. *They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more.* Reorganization in the most ordinary sense suggests 'the formation of a new corporation that is in financial difficulties, for the purpose of purchasing the company's works and other property, after the foreclosure of a mortgage or judicial sale.' Morawetz Corp. § 812; Symmes v. Union Trust Co. (C.C.) 60 F. 830. While the term includes financial readjustments in ways other than by judicial sale, *it does not properly embrace mere purchases by one company of the assets of another.* * * * A sale of the assets of one corporation to another for cash without

> the retention of any interest by the seller in the purchaser is quite outside the objects of merger and consolidation statutes." (Emphasis added)

In *Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue,* 287 U.S. 462, this Court said at p. 470:

> "But the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption the seller *must acquire an interest in the affairs of the purchasing company* more definite than that incident to ownership of its short-term purchase-money notes. This general view is adopted and well sustained in Cortlandt Specialty Co. v. Commissioner of Internal Revenue, 60 F.(2d) 937, 939, 940. It harmonizes with the underlying purpose of the provisions in respect of exemptions and gives some effect to all the words employed." (Emphasis added).

We specifically call to the attention of the Court that sec. 368(a)(1)(D) of the 1954 Code is exactly like sec. 112(g)(1)(D) of the 1939 Code except that the 1954 Code added the following specific provision:

> *"but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356;"* (Emphasis added)

Both the Tax Court and the Court of Appeals stated that they would give no effect to that provision of (D) because it would be useless to require any stock to be distributed when the same stockholders owned stock in both the Warehouse Company and the Water Company. This is an ex-

tremely important point and we would like for the Court to bear with us very briefly.

The Tax Court ignored this provision simply on the ground of the decision in *James Armour, Inc.*, 43 T.C. 295. That Court, after referring to cases cited by both parties, said (R.Vol.I, 245-246, 248-250):

> "No purpose would be served in discussing these various cases since the facts in the instant case are indistinguishable from the facts in James Armour, Inc., 43 T.C. . . . (Dec. 4, 1964), and on the basis of our decision therein we hold that the transfer by Warehouse of its assets to Water Company constituted a reorganization under section 368(a)(1)(D).
>
> * * *
>
> "Since no distinction exists between James Armour, Inc., supra, and the instant case, we hold that the result of the whole transaction here was a reorganization under section 368(a)(1)(D) and that under sections 354 and 356 petitioners received a taxable dividend to the extent of the earnings and profits of Warehouse. Further, following our decision in James Armour, Inc., supra, we hold that the amount of the distribution by Warehouse through Homer L. Bruce, Jr., to petitioners was a dividend only to the extent of the earnings and profits of Warehouse and the balance is to be treated as capital gains to the extent that it exceeds the basis of petitioners in their stock."

In the *Armour* case, 43 T.C. 295, the Tax Court in dealing with this same sec. 368(a)(1)(D) said in reference to the requirement that stock be distributed at 43 T.C. 307:

> "However, the petitioners already owned all the stock of Excavating and it was not necessary that

> further stock be issued in order that they might retain their same proprietary interest in the assets received by Excavating. *The issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act.* We conclude, therefore, that there was in substance an exchange of stock of Armour, Inc. for stock of Excavating, which meets the requirements of sections 354 and 356 of the Code (sec. 355 has no application here). See Commissioner v. Morgan, supra, where, in an analogous situation, the court held that the stock exchange requirements of section 112(b)(3) and (c) of the Internal Revenue Code of 1939 (corresponding to secs. 354(a)(1) and 356(a)(1)(B) of the 1954 Code) were met." (Emphasis added)

Thus it will be seen that the Tax Court relied below on the *Morgan* case. The Court of Appeals likewise simply blindly relied on the *Morgan* case saying (R.Vol.III, 646):

> "'*Here, the issuance of new stock would have been a meaningless gesture* * * *.' *Commissioner v. Morgan, supra; accord, Liddon v. Commissioner,* 230 F.2d 304 (6 Cir. 1956)."

Let us look at the *Morgan* case, *C.I.R. v. Morgan,* 288 F.2d 676. That was a decision by Judges Staley, Kalodner and Hastie of the Third Circuit Court of Appeals, with Judge Hastie vigorously dissenting. There was a transfer of assets from one corporation to another involving the same people, and the question was whether it was a reorganization under the 1939 Code when no new stock was issued. The two judges deciding the case held there was no necessity for any new stock, saying without citing any authority whatsoever, at 288 F.2d 680:

> "Here, the issuance of new stock would have been a meaningless gesture since the stock the taxpayer already

held represented the total value of all the assets except for the boot."

Judge Hastie strongly dissented from that holding, saying at 288 F.2d 681:

> "It is argued, however, that in this case no transfer of stock of a corporation to the taxpayer is the legal equivalent of an actual stock transfer merely because the taxpayer already was and long had been sole stockholder of that corporation. I can see no logical basis for thus finding an exchange of stock within the statutory requirement without any demonstration that something happened in this case which was equivalent to a transfer of stock to the taxpayer."

Thus we have the *Morgan* case decided by a two to one vote in the Third Circuit where the majority simply stated that it would be a meaningless gesture for stock to be issued, and on the basis of that decision the Tax Court in *James Armour, Inc.* and in this case and the Court of Appeals below have said that they will disregard the provision specifically placed by Congress in (D) that stock must be distributed that qualifies under sec. 354. We quote the following from the report of the Senate Finance Committee on the Internal Revenue Code of 1954 at page 274 in reference to this addition to this clause (D):

> "Subparagraph (D) also explicitly states that a transaction of the type described is only to be considered a reorganization when the stock and securities of the transferee corporation or corporations are distributed to the shareholders and security holders under the terms of section 354, 355, or 356. However, where there is no such distribution, the transaction may, nevertheless, result in nonrecognition of gain or loss to the transferor corporation under the terms of section 351." (Emphasis added)

We submit that this is a question that this Court should pass upon, that is, whether this explicit provision in Clause D may be completely ignored by the courts in determining whether there is a reorganization.

3. The Court of Appeals held there was a reorganization under both 368(a)(1)(D) and (F). It then held that the $700,000 paid by the Water Company to the Warehouse Company and the $200,000 of the Warehouse Company's own money were dividends to petitioners to the extent of the earnings of both the Water Company and the Warehouse Company.

In the first place such a holding assumes that something came to the petitioners that qualified under sec. 354 and that they received in addition cash from Warehouse. Sec. 356 provides that, if the property received by petitioners consisted not only of stock permitted under sec. 354 but of other property, then the gain to petitioners in the amount of the money received is to be treated as a dividend. Frankly, no other court has ever held that the word "dividend" in sec. 356 would apply to either company except the one distributing the taxable property, in this case, the Warehouse Company. This is the first time to our knowledge that any such contention has been made by the Government, that the words "distribution of a dividend" in sec. 356 could apply to both the Warehouse Company and the Water Company. This holding by the Court of Appeals was directly contrary to that of the Tax Court. We submit that this Court should pass upon this case and should correct this plain misinterpretation of sec. 356.

In addition, this Court in *Commissioner v. Palmer*, 302 U.S. 63, held that, where a corporation sold part of its assets to its stockholders at their fair value, this did not result in any diminution of the corporation's net worth

and therefore was not a dividend. In this case, if we ignore the sale to Homer L. Bruce, Jr., the Water Company transferred $700,000 of its cash to the Warehouse Company for its assets, which both Courts below held were worth $700,000, but transfer of the $700,000 cash by the Water Company to the Warehouse Company would not in any way diminish the net worth of the Water Company. When, therefore, the Court of Appeals held that this was a dividend from the Water Company, its holding was directly contrary to that of this Court in the *Palmer* case.

Sec. 316 of the Code defines a dividend as follows:

> "Sec. 316. DIVIDEND DEFINED.
>
> (a) GENERAL RULE.—For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders—
>
> (1) out of its earnings and profits accumulated after February 28, 1913, or
>
> (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

Certainly, when the Water Company paid out $700,000 in cash and received back property worth $700,000, this was not the distribution of a dividend as defined by sec. 316.

4. If there were no reorganization under sec. 368(a)(1)(D) or (F) of the Code, then the holding that the stockholders received a dividend from the Water Company is directly in conflict with *Rodman Wanamaker Trust*, 11 T.C. 365, *Emma Cramer*, 20 T.C. 679 *Trianon Hotel Company*, 30 T.C. 156, *C.I.R. v. Pope*, 239 F.2d 881, (1st C.C.A.), and the refusal by Congress in the Revenue Act

of 1950 and in the 1954 Code and later Revenue Acts to provide that the purchase of the assets of one corporation by a commonly controlled corporation would be a dividend.

Prior to 1950 sec. 115 (g) of the 1939 Code simply provided that, if a corporation redeemed its stock in such manner as to make the redemption essentially equivalent to a dividend, the amount should be treated as a taxable dividend. In *Rodman Wanamaker Trust*, 11 T.C. 365 (1948), supra, the Tax Court held that the purchase of stock in a parent company by a subsidiary was not a dividend to the stockholders in the parent company selling their stock. Thereafter Congress, by sec. 208 of the Revenue Act of 1950, amended sec. 115 (g) to provide that, if stock of a parent company were acquired by a subsidiary, the amount paid for the stock would be a taxable dividend from the parent company. As shown by the report of the House Ways and Means Committee on the 1950 Revenue Act, (1950—2 C.B. 444) this action was taken in the light of the *Rodman Wanamaker Trust* case and applied only to the acquisition of stock of a parent corporation by a subsidiary. It further showed that the House Committee tried to put in a provision making it a dividend for one commonly controlled company to buy the stock of another commonly controlled company. The Senate Finance Committee refused to take this second step (1950—2 C.B. 514-515, 541). In the Conference Report it is stated in reference to this amendment that

> "The Senate amendment limits the application of the bill to purchases by a subsidiary." (1950—2 C.B. 584).

In *Emma Cramer*, 20 T.C. 679 (1953), the Court rejected the argument of the Commissioner that the sale of stock in one corporation to a commonly held corporation would be a dividend. Following that decision Congress

enacted sec. 304 of the 1954 Code (Appendix B, infra p. 59). Even there they made the purchase by a commonly controlled corporation apply only to stock of another commonly controlled corporation and not to a purchase of assets.

In *Trianon Hotel Company*, 30 T.C. 156, the Government still contended in 1958 that under the 1950 Act, if one corporation acquired the stock of a commonly held corporation for cash and notes, this would be a dividend. The Tax Court rejected this contention and the Commissioner finally gave up and in 1959-1 C.B. 5 acquiesced in the *Trianon* case and in 1960-1 C.B. 4 and 6 acquiesced in the *Emma Cramer* and *Rodman Wanamaker* cases.

We submit, therefore, that in the light of sec. 304 of the Code the purchase of the assets of the Warehouse Company by the Water Company and the distribution of that money by the Warehouse Company cannot be a dividend to petitioners.

5 and 6. The Court of Appeals held that, since petitioners could have had the Warehouse Company transfer its properties to the Water Company for stock in a tax free transaction with no distribution of any cash to them, it would ignore what was done and proceeded to break these things down into three transactions, (a) the payment of a $700,000 dividend by the Water Company, (b) the payment of a $200,000 dividend by the Warehouse Company, and (c) the transfer of Warehouse assets to Water Company. This is in direct conflict with the holding in *Gregory v. Helvering*, 293 U.S. 465, that taxpayers may arrange their transactions in such a way as to minimize their taxes, and is directly contrary to *Commissioner v. Brown*, 380 U.S. 563, *Old Colony Railroad Co. v. C.I.R.*, 284 U.S. 552, *Helvering v. Hammel*, 311 U.S. 504, *Helvering v. Flaccus*

Leather Co., 313 U.S. 247, *Hanover Bank v. C.I.R.*, 369 U.S. 672, and *Turnbow v. C.I.R.*, 368 U.S. 337, all of which lay down the rule that the Internal Revenue Code must be applied in accordance with the words in which it is written. We have never seen a holding go anything like the length of the holding in this case by the Court of Appeals, and we submit that it clearly lays down an untenable rule of law. For example, this Court said in *Commissioner v. Brown*, 380 U.S. 563, 571:

> " 'Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words 'sale' and 'exchange' are not to be read any differently.' Helvering v. Flaccus Leather Co., 313 U.S. 247, 249; Hanover Bank v. Commissioner, 369 U.S. 672, 687; Commissioner v. Korell, 339 U.S. 619, 627-628; Crane v. Commissioner, 331 U.S. 1, 6; Lang v. Commissioner, 289 U.S. 109, 111; Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560."

7. The Courts below were not authorized to ignore the sale by petitioners of their stock in the Warehouse Company to Homer L. Bruce, Jr.

There was nothing hidden about this sale. We told the Court that the undersigned, Homer L. Bruce, advised petitioners as their attorney that they as stockholders of the Warehouse Company might adopt a plan of liquidation and then have it sell its properties to the Water Company for $700,000 cash and then distribute the $700,000 with its additional cash of about $200,000 and they would be taxed on a capital gains basis. He further said that he told them some revenue agent might bring this up as a reorganization, and that under *W. P. Hobby*, 2 T.C. 980, and *Sun Properties, Inc.*, 220 F.2d 171, they could sell the stock of the Warehouse Company to an outsider and let him

attend to the liquidation of the Warehouse Company. He did not suggest his son, Homer L. Bruce, Jr., but S. M. Clements suggested him because they lived across the street from each other. The said Bruce, Jr. bought the stock and made a $15,000 profit. J. E. Davant and William S. Fly, who were lawyers, testified that they would not have gone into it except through the sale to H. L. Bruce, Jr. (R. Vol. II, 46-49, 113). The Court of Appeals said there was no substance in this sale but we submit there was as much substance in that sale as there was in the sale that this Court approved in *Commissioner v. Brown,* 380 U.S. 563, on April 27, 1965. It had as much substance and was as valid as similar sales that were approved in *W. P. Hobby,* 2 T.C. 980; *Sun Properties, Inc. v. U. S.,* 220 F.2d 171; *John D. McKee et al., Trustees,* 35 B.T.A. 239, acq. 1937-1 C.B. 15; *Clara M. Tully Trust,* 1 T.C. 611 acq. 1943-C.B. 23; *Rose M. Everett,* 4 T.C.M. 454; *Avco Manufacturing Co.,* 25 T.C. 975.

Conclusion

For the foregoing reasons, your petitioners respectfully pray that this petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

NO. 22,835

J. E. DAVANT and KATHRYN DAVANT, ET AL.,
Petitioners

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent

(AND REVERSE TITLE)

Petitions for Review of Decisions of the Tax Court of the United States (Texas Case)

(August 22, 1966.)

Before RIVES and BELL, Circuit Judges, and FULTON, District Judge.

RIVES, Circuit Judge: The petitioners are persons who claim that the income from the sale of their stock

in the South Texas Rice Warehouse Company should be taxed solely as a capital gain. The Tax Court found that a corporate reorganization had taken place and held that at least part of petitioners' income should be taxed as a dividend constituting ordinary income.[1] The government took a cross appeal contending that the Tax Court should have held that a greater portion of petitioners' income was ordinary income. Since we agree with the government, we affirm in part and reverse in part.

South Texas Rice Warehouse Co.[2] was incorporated under the laws of the State of Texas in 1936. The principal business of Warehouse consisted of drying, cleaning, and storing rice.[3] Warehouse's principal source of rice was land owned by a brother corporation, South Texas Water Co.[4]

Water was incorporated under the laws of the State of Texas in 1934. Water had two principal businesses. It owned land which it rented to a partnership, South Texas Rice Farms,[5] and it owned and operated an

1. The opinion of the Tax Court is reported at 43 T.C. 540 (1965). A companion case, South Texas Rice Warehouse Co. v. Comm'r, No. 22,834, ____ F.2d ____ (19), is presently pending before this panel. The Tax Court decided both cases in the same opinion and they were in effect argued together before this Court. Since they involve separate issues, we have elected to decide them separately.

2. Hereafter, Warehouse.

3. Although not relevant to this opinion, in June of 1957 Warehouse leased its operating assets to a partnership involving members of the same families involved in this litigation. The tax consequences of that lease arrangement are the subject of the companion case, South Texas Rice Warehouse Co. v. Comm'r, No. 22,834, ____ F.2d ____ (19).

4. Hereafter, Water.

5. Hereafter, Farms.

irrigation canal system used to irrigate the ricelands that it leased to Farms.

The principal business of Farms was re-leasing the land rented from Water to tenant farmers on a sharecrop arrangement. Generally, the tenant retained 50% of the rice produced and Farms received the other 50% as payment for the land provided.

The riceland which was leased by Farms from Water was irrigated by Water and the rice which Farms received from its tenants was put through Warehouse's dryer and stored by Warehouse. Water's lessees generally put their rice through Warehouse's dryer, and then stored their rice in Warehouse's facilities.

Warehouse and Water were each owned in equal proportions by four families.[6] The partners in Farms were the same persons who were the stockholders of Warehouse and Water and their respective interests were in substantially the same proportions as their stock ownership in the

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6.

"Owner of Stock	Percent of individual ownership	Percent owned by each family as a group
"L. D. Clements	20	
Thurman S. Clements	2-1/2	25
Betty Dickson Clements Fly and William S. Fly	2-1/2	
"John E. Davant	7-6/7	
Kathryn Devant Dodson	7-1/7	25
Mary Anne Davant Dunnam	7-1/7	
Hortense E. Davant	2-6/7	
"S. M. Clements	15	
Marlenne Clements Clark and E. W. Clark	10	25
"Raye W. Pegram	8	25
R. Q. Pegram, Jr.	8	
Joyce Pegram Jones	3	
Peggy Pegram Elliott	3	
Ray Beth Foster	3 "	

two corporations. The books and records of these three enterprises, while separately prepared, were all kept in the same office.

In 1960 a number of the stockholders consulted an attorney, Homer L. Bruce, Esq., about the possibility of transferring Warehouse's operating assets to Water for $700,000 and then liquidating Warehouse. This attorney had represented Warehouse, Water, and their stockholders for many years.

In the attorney's opinion, section 337[7] would allow the individuals to obtain capital gains treatment for any income they might receive in the transaction they contemplated.[8] However, Mr. Bruce advised against such a course of conduct. He told them that in a situation where such a sale and distribution was made when the stockholders of the two corporations were identical it was probable that the Internal Revenue Service would take the position that the stockholders had received a dividend taxable at ordinary rates and not a capital gain.

Mr. Bruce then suggested an alternate course of conduct which he believed would have the desired effect of having any gains taxed at the capital rather than the ordinary rate. The suggestion was that if the stockholders made a sale of their stock to a person not connected with them or their corporations at a fair price which would allow that person to make a reasonable profit, then that person could sell Warehouse's operating assets to Water and liquidate Warehouse without endangering the original stockholders' capital gains treatment.

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7. All section references in this opinion are to the Internal Revenue Code of 1954 unless otherwise stated.

8. While the attorney spoke in terms of section 337, he, of course, meant sections 337 and 331.

Homer L. Bruce, Jr., a practicing attorney and the son of petitioners' attorney, was suggested by one of the stockholders as an appropriate person to buy their stock. Both Water and Warehouse had a corporate account with the Bank of the Southwest[9] and the Bank had for many years been represented by Mr. Bruce's law firm.

Mr. Bruce contacted A. M. Ball, a vice-president of the Bank. He told Mr. Ball that his son wished to buy Warehouse for $914,200 and wished to borrow the necessary funds from the Bank. The stock of Warehouse was to be the collateral for the $914,200 note of Bruce, Jr. It was understood that Water would then buy the assets of Warehouse for $700,000, and that this money plus part of the approximately $230,000 which Warehouse had in its bank account would be used, after Warehouse was liquidated, to repay the loan. This procedure allowed Bruce, Jr. to receive $15,583.30 for his part in the transaction, and allowed the Bank to receive what the parties designated as one day's interest on its $914,200 loan or $152.37.

Homer L. Bruce, Jr. was not present during his father's discussions with Mr. Ball nor did Bruce, Jr. participate in the discussions which determined that $914,200 should be the purchase price for the Warehouse stock and $700,000 the purchase price of Warehouse's operating assets to be paid by Water. No appraisals were made of the properties of Warehouse during 1960, although the Tax Court later found their fair market value to be at least the $700,000 paid for them by Water. The Bank loaned Bruce, Jr. $914,200, yet was never furnished a statement of his finances nor an appraisal or statement on Warehouse.

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9. Hereafter, Bank.

Mr. Ball, who approved the $914,200 loan, had no authority to approve loans in excess of $25,000 without prior approval of the Bank's discount committee. This particular transaction was not approved by the discount committee until after it was entirely a *fait accompli.*

On August 26, 1960 the stockholders of Warehouse, Mr. Ball, Mr. Bruce and his son met at the Bank. In accordance with a detailed instruction sheet,[10] the respective parties went through the motions of making a loan, selling stock, electing new corporate officials, selling Warehouse's assets, liquidating Warehouse, and repaying the loan. Thanks to the careful prearrangement of all the details, the parties were able to act out their respective roles in approximately one hour.[11]

In terms of the actual physical carrying on of Warehouse's business, absolutely no disruption was occasioned by the paper transfer to Water. Every part of the business was carried on as before with the sole change being that it was necessary to keep one less set of books at the office. August 26 came during the busy rice drying season, but for those physically involved in carrying on Warehouse's business affairs, August 26, 1960 came and went like any other day—the dryers kept right on drying.

Petitioners take the position that the sale of their stock in Warehouse to Bruce, Jr. was a *bona fide* sale and that they properly reported their profits as the gain from the sale of a capital asset held over six months. The Com-

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10. The instruction sheet is reproduced in the opinion of the Tax Court. 43 T.C. 540 (1965) at 553-55.

11. In addition to the instruction sheet, all of the necessary documents had been prepared in advance. These documents included the necessary papers for Warehouse's "sale" of its operating assets to Water.

missioner argues that the transaction involved in this case is a corporate reorganization and that to the extent of the earnings and profits of both Warehouse and Water the gain reported here must be considered as a dividend taxable as ordinary income. The Tax Court held that the instant transaction constituted a corporate reorganization coming under section 368 (a) (1) (D) of the Internal Revenue Code of 1954. However, the Tax Court also held that the gain was taxable as a dividend only to the extent of Warehouse's earnings and profits.[12]

We stand now at the threshold of our travel through the detailed and complex Code provisions that must govern our determination. Before we embark upon that journey it is well to restate the general principle that rules prescribed by Congress in the Code are often wholly reasonable and appropriate when taken in isolation, but that fact alone should not and must not prevent a court from harmonizing these apparently divergent elements of specific policy so that they may continue to cohabit the same body of general law which Congress has directed shall be viewed as a single plan.[13] As Mr. Justice Frankfurther so aptly stated, "There are no talismanic words that can avoid the process of judgment."[14]

In order to effectuate the intent of Congress the dividend, liquidation, redemption and reorganization sections of the Code must be examined and viewed as a functional

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12. The term "earnings and profits" is a term of art. Although it is not defined in the code, it has a well-settled meaning. For an explanation of the method of computing earnings and profits, see Bittker, Federal Income Taxation of Corporations and Shareholders (1959 ed.) sec. 5.04.

13. Cf. Bazley v. Commissioner, 331 U.S. 737 (1947).

14. Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951), at 489.

whole. The basic framework by which Congress sought to tax corporate distributions is contained in sections 301(a), 301(c) and 316. Distributions of corporate funds to stockholders made with respect to their stockholdings must be included in their gross income to the extent that those distributions are made out of the corporation's earnings and profits. Such distributions are termed by the Code as dividends and are taxed as ordinary income.[15]

All of the steps taken by taxpayer in this case with regard to the $200,000 worth of earnings and profits generated by Warehouse and the $700,000 worth of earnings and profits generated by Water were for the sole purpose of turning what otherwise would be a dividend

15. Section 302 allows a redemption of corporate stock to receive capital gains treatment only if it "is not essentially equivalent to a dividend"; section 346 allows a partial liquidation of a corporation to receive capital gains treatment only if it is part of a complete liquidation or "is not essentially equivalent to a dividend"; sections 354, 355, 356 each contain a "boot" provision that deprives a distribution of capital gains treatment if it "has the effect of the distribution of a dividend"; section 351 also contains a "boot" provision; section 357 prevents a corporation from distributing a disguised dividend by assuming a stockholder's liability (for example, as part of a 351 transaction) where such an assumption would have a "purpose to avoid federal income tax"; section 306 prevents the use of preferred stock to convert what would be ordinary income into a capital gain by treating it "as a dividend" to the extent of the gain realized on its sale or exchange. Cf. section 304, which prevents a disguised dividend by having the stock of one corporation redeemed by its brother corporation. In only one situation does the Code intend that a taxpayer should be allowed to receive the earnings and profits of his corporation without running the gauntlet of 301-316 or the equivalent boot provisions. That is where the taxpayer intends to stop employing the corporate form in administering that business, i.e., a bona fide complete liquidation under section 331 or its equivalent, where taxpayer sells all of his stock in a corporation and terminates his proprietary interest in those assets.

taxed at the ordinary income rate into a gain made on the sale or exchange of a capital asset taxed at the much lower capital gains rate.

First, petitioners tell us that all they have done is sell their entire stock interest in Warehouse in a *bona fide* sale to an outside party. The sale of all of one's stock in a corporation, thus terminating taxpayer's proprietary interest in a corporation and its assets, is probably one of the most common forms of capital sales. But the Tax Court held, "The facts in this case show that Homer L. Bruce, Jr., was not a purchaser of the stock in any real sense but merely a conduit through which funds passed from Water Co. to Warehouse and from Warehouse to petitioners."[16] In this Court petitioners stress the fact that there was never a binding, written obligation on Water to buy Warehouse's assets or on Bruce, Jr. to sell them. Like the Tax Court, in view of all the circumstances, we can attach very little importance to the absence of any written obligations.[17]

For the purposes of the personal income tax provisions, courts have never been shackled to mere paper subterfuges. It is hard to imagine a transaction more devoid of substance than the purported "sale" to Bruce, Jr. In *United States v. General Geophysical Co.*, 296 F.2d 86 (5 Cir. 1961), the government argued that this Court should always disregard the form of a transaction and look to the substance or reality of the transaction. Speaking through Judge Wisdom, this Court announced the following rule for judging when substance should predominate (296 F.2d at 87-89):

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16. 43 T.C. 540 (1965), at 567.

17. Cf. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); United States v. General Geophysical Co., 296 F.2d 86 (5 Cir. 1961).

> "The solution of hard tax cases requires something more than the easy generalization that the substance rather than the form of a transaction is determinative of its tax effect, since in numerous situations the form by which a transaction is effected does influence or control its tax consequences.
>
> * * * * * * *
>
> "Each case must be decided on its own merits by examining the form and substance of the transactions and the *purpose of the relevant tax provisions to determine whether recognition of the form of the transaction would defeat the statutory purpose.*" (Emphasis added.)

Congress has provided in great detail what the tax consequences of a reorganization or partial or complete liquidation of a corporation should be. The tax consequences of this transaction must be judged by those standards because to allow the "sale" to Bruce, Jr. to divert our attention from the tax policies enacted by Congress would be to exalt form above all other criteria. He served no function other than to divert our attention and avoid tax. Stated another way, his presence served no ligitimate nontax-avoidance business purpose. *Cf. Commissioner v. Court Holding Co.*, 324 U.S. 331, 324 U.S. 331 (1945); *Campbell v. Wheeler*, 342 F.2d 837 (5 Cir. 1965); *United States v. Lynch*, 192 F.2d 718 (9 Cir. 1951), *cert. den.*, 343 U.S. 934 (1952); *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570 (2 Cir. (1949), *cert. den.*, 338 U.S. 955 (1950); *Fox v. Harrison*, 145 F.2d 238 (7 Cir. 1944); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2 Cir. 1954), *cert den.*, 349 U.S. 906 (1955).

In the *Court Holding* case, the Supreme Court, in reversing a decision by this Court, said (324 U.S. at 333-34):

> "The Tax Court concluded from these facts that, despite the declaration of a 'liquidating dividend' followed by the transfers of legal title, the corporatoin had not abandoned the sales negotiations; that these [liquidating dividends] were mere formalities designed 'to make the transaction appear to be other than what it was,' in order to avoid tax liability.
>
> * * * * * * *
>
> "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. * * * A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[18]

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18. In **Bazley** the Supreme Court adopted a rationale which would require that "a new arrangement intrinsically partake of the elements of "a sale" which underlie the Congressional exemption [of sales of stock from 301-316 treatment] and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation "of a sham sale which transferred earnings" to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity [from sections 301-316] because cast in the form of a" sale. "The governing legal rule can hardly be stated more narrowly. To attempt to do so would only challenge astuteness in evading it." **Bazley v. Commissioner**, 331 U.S. 737 (1947), at 742.

The petitioners insist that, even if we recognize that Bruce, Jr. was merely their agent and impute his acts to them, they are entitled to capital gains treatment. They stress that they did no more than completely liquidate Warehouse corporation, which entitled them to a capital gain under section 331. The sale to Water of Warehouse's operating assets should not be treated as a taxable event, the petitioners argue, because of section 337. The "general rule" pronounced by section 337 is that if a corporation adopts a plan of complete liquidation and distributes all of its assets in complete liquidation within 12 months after the date the plan was adopted, no recognition of gain or loss shall be recognized on the sale of its property made during those 12 months.

Section 331 provides that when a corporation is completely liquidated section 301 is inapplicable and the gain shall be treated as if derived from a sale or exchange of the stock. In short, the gain is to be treated as a capital gain. It would appear at first blush that petitioners have carefully fitted themselves directly within the statutory wording. But in the landmark case of *Gregory v. Helvering*, 293 U.S. 465 (1935) the Supreme Court refused to give effect to a corporate transaction which complied precisely with the formal requirements for a nontaxable corporate reorganization, on the ground that the transaction had served no function other than that of a contrivance to bail out corporate earnings at capital gains tax rates.[19] That is precisely the charge made here. Let us examine what legitimate purposes might be served by the transactions

19. In **Bazley v. Commissioner**, 331 U.S. 737 (1947), the Supreme Court again refused to give effect to a corporate transaction which complied precisely with the formal requirements for a nontaxable corporate reorganization, on the ground that the transaction was an attempt to bail out corporate earnings.

here under consideration. Three distinct and separate things occurred.

First, $700,000 in earnings and profits possessed by Water were passed through Warehouse to petitioners. Second, $200,000 in earnings and profits from Warehouse were distributed to petitioners. Third, the operating assets of Warehouse were combined with Water and were from that point on owned and controlled through Water. Only one business nontax-avoidance purpose can be found to support any of these events: petitioners wished to eliminate one of the corporate shells and thereafter control all of the properties under one roof. This motive legitimately explains why petitioners transferred the operating assets of Warehouse to Water. But it does not explain either of the first two steps. Under the reorganization provisions of the Code petitioners could have transferred all of Warehouse's assets, including its earnings and profits, to Water without paying any tax. Thus the payment of $200,000 from Warehouse to petitioners cannot be explained as necessary in order to place both businesses under the same roof. Likewise, there was no need for petitioners to cast the transfer of Warehouse's operating assets in the form of a sale. The businesses could be combined under one roof without the $700,000 from Water ever coming over to Warehouse. It is apparent that no functional relationship exists between either the $200,000 coming to petitioners from Warehouse or the $700,000 coming to petitioners from Water and the transfer of Warehouse's assets to Water. Petitioners make no attempt to provide a nontax-avoidance purpose for their actions, but instead argue that these events cannot be a reorganization because they do not come under the literal language of the reorganization provisions. They then reason they must be a complete

liquidation since they do come under the literal language of the complete liquidation provisions. As Justice Frankfurter once put it, "The syllogism is perfect. But this is a bit of verbal logic from which the meaning of things has evaporated."[20]

Clearly, this liquidation cannot come within the intention of Congress in enacting the complete liquidation provisions. Those provisions contemplate that operating assets will no longer be used by the stockholders to carry on the business as a corporation. It has long been recognized that taxpayers cannot liquidate a corporation with the intention of immediately reincorporating it in order to hold back liquid assets and cash for the purpose of getting capital gains treatment or to obtain a stepped-up basis for the operating assets or to wipe out old earnings and profits or other tax attributes. Such a liquidation reincorporation transaction does not qualify for section 331 treatment. In *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), the Supreme Court affirmed an appeal from this Circuit in which this Court had held that a series of events must be construed as a single transaction coming within the reorganization provisions, even though they did not meet its literal language.[21] The Supreme Court said (315 U.S. at 184-85):

> "[T]he separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts [i.e., the liquidation and reorganization

20. Phelps Dodge Corp. v. NLRB, 313 U.S. 177 (1941), at 191.

21. Taxpayer had sought a recognition of each step in a preconceived plan by which the bankrupt corporation first transferred its assets to its creditors and they then reincorporated them.

> provisions] where they add nothing of substance to the completed affair. [Citations omitted.] Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan."

See *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2 Cir. 1954), *cert. den.*, 349 U.S. 906 (1955); *Survaunt v. Commissioner*, 162 F.2d 753 (8 Cir. 1947); *Lewis v. Commissioner*, 176 F.2d 646 (1 Cir. 1949). Applying the concept that we must look at petitioners' plan as a whole to the extent that the parts are functionally related, and not at its constituent parts individually, for the purpose of determining whether section 331 applies, we conclude that section 331 does not apply in this case.

Petitioners never intended to give up the corporate form of doing business. At all times relevant their intention was to transfer Warehouse's operating assets to Water. Water and Warehouse were owned by identical shareholders with identical distribution of shares. At no time did the petitioners' interest in the operating assets change. Most of the reported cases involve situations where the stockholders create a new corporate shell to receive the assets, but we see no difference between a liquidation followed by a transfer to a new corporate shell and a liquidation followed by a transfer to an already existing corporate shell.[22]

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22. This liquidation does not "intrinsically partake of the elements" "which underlie the congressional exemption" from ordinary gains tax treatment in section 331. Bazley v. Commissioner, 331 U.S. 737 (1947), at 742. Here, the transfer of all of the operating assets to Water within the same hour as the liquidation meant that petitioners continued to carry on their business using the corporate form just as before.

Since this interchange of events cannot be viewed as a complete liquidation, we must now decide, for the purposes of the federal tax code, what it is. In the Tax Court the Government contended that this was a 368 (a) (1) (D) or (F) reorganization.

A section 368 (a) (1) (F) reorganization is defined as "a mere change in identity, form, or place of organization, however effected." Since the Tax Court held that this transaction was a (D) reorganization, it apparently believed that it was unnecessary to decide the (F) question. In the past, type (F) reorganizations have overlapped with type (A), (C) and (D) reorganizations. For this reason this provision has received almost no administrative or judicial attention. It is true that a substantial shift in the proprietary interest in a corporation accompanying a reorganization can hardly be characterized as a mere change in identity or form. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

The term "mere change in identity [or] form" obviously refers to a situation which represents a mere change in *form* as opposed to a change in substance. Whatever the outer limits of section 368 (a) (1) (F), it can clearly be applied where the corporate enterprise continues uninterrupted, except for a distribution of some liquid assets or cash. Under such circumstances, there is a change of corporate vehicles but not a change in substance. If Water had no assets of its own prior to the transfer of Warehouse's operating assets to it, could we say that Water was any more than the alter ego of Warehouse? The answer is no. The fact that Water already had other assets that were vertically integrated with Warehouse's assets does not change the fact that Water was Warehouse's alter ego. Viewed in this way, it can make no practical difference

whether the operating assets were held by Water or Warehouse, and a shift between them is a mere change in identity or form. At least where there is a complete identity of shareholders and their proprietary interests, as here, we hold that the type of transaction involved is a type (F) reorganization.

In the alternative, we also hold that the Tax Court correctly held that these events constituted a 368 (a) (1) (D) reorganization. The (D) question is more complex than the (F) question. Section 368 (a) (1) (D) defines a corporate reorganization as:

> "[1] a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; [2] but only if, in pursuance of the plan, *stock or securities* of the corporation to which the assets are transferred *are distributed in a transaction which qualifies under section 354, 355, or 356* * * *." (Emphasis added.)

In this case, it is clear that the petitioners have satisfied part one of the type (D) definition. Warehouse is a "corporation" and it transferred "a part of its assets to another corporation," Water. Since both corporations were owned identically by petitioners the "control" requisite was fulfilled.

Petitioners argue that the provision cannot apply to them because in part two Congress specifically required that

"stock or securities" of the transferee corporation be passed to petitioners. They, of course, point out that they received no new stock in Water as a part of their transaction. We cannot agree that this statutory requirement must be taken literally, especially where it would prevent the effectuation of the tax policies of Congress.

The (D) reorganization provisions have never been confined to a strictly literal application. It will be noted that section 368(a)(1)(D) requires that the transferor be "a corporation." But it has been consistently held that a proper interpretation and application does not prevent from coming under the aegis of 368(a)(1)(D) a transfer made by "persons" who have received assets from a corporation with the intention of transferring them to another corporation. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2 Cir. 1954).

Nor in ascertaining the intention of Congress should we ignore the function intended for part two of the type (D) definition. Section 368 is not an operative provision but merely defines what Congress meant by the term reorganization. The operative provisions for a 368 (a)(1)(D) reorganization are those which Congress had cited, sections 354, 355 and 356. These latter three sections determine what will be the tax consequences of a type (D) reorganization.

Congress realized that splitting up a corporation or merging two corporations were not events that normally justified the imposition of a tax on stockholders. If a stockholder merely traded one stock certificate for another he would have no cash or liquid assets with which to pay a tax. To Congress these reorganizations were essen-

tially a change in form.[23] As a general rule, however, an "exchange" of stock is taxed.

In order to give taxpayers relief from this general rule of taxation where no liquid assets or cash are realized, Congress enacted the reorganization provisions. But inherent in the reorganization provisions were two evils which Congress also attempted to avoid.

The first was that a taxpayer might wish to disguise *a sale* of his proprietary interest as a tax free reorganization and by that means avoid all tax. This type of evasion has been disapproved. *Turbow v. Commissioner*, 368 U.S. 337 (1961), at 343, where the Supreme Court said:

> "To indulge such an assumption [as the taxpayer made] would actually be to permit the negation of Congress' carefully composed definition and use of 'reorganization' in those subsections, and to permit nonrecognition of gains *on what are, in reality, only sales*, the full gain from which is immediately recognized and taxed under the rule * * *." (Emphasis added.)

Cf. LeTulle v. Scofield, 308 U.S. 415 (1940).

The second evil, the converse of the first, is where a taxpayer attempts to disguise a reorganization as a sale in order to obtain the more favorable tax benefits that a sale sometimes provides. See *Helvering v. Alabama Asphaltic*

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23. See Bazley v. Commissioner, 331 U.S. 737 (1947) at 740-41. "As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain. These considerations underlie [section 368] and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose."

Limestone Co., 315 U.S. 179 (1942); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2 Cir. 1954), *cert. den.*, 349 U.S. 906 (1955). Of course, this is the same as where a corporation is liquidated and its operating assets are then conveyed to a new corporation in a section 351 transaction.[24] In the reorganization provisions themselves, Congress has attempted to provide for taxing the syphoning off of liquid assets in the course of a reorganization.

In sections 354, 355 and 356 Congress has provided for the tax consequences of holding out cash or liquid assets in a 368 (a) (1) (D) reorganization. Congress has drawn these provisions to cover the normal procedure for a taxpayer legitimately wishing to take advantage of the taxfree reorganization provisions. It is only natural then that Congress would speak in terms of stock transferred in the course of a reorganization. The exchange of stock in the course of a legitimate reorganization was the specific case most likely to occur to the mind and the most logical way to draw the statute. The fact that Congress drew the statute to fit the

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24. There are actually three common garden varieties of this disguised reorganization device. 1. The original corporation can transfer property to a new corporation, receiving back the new corporation's stock. This stock along with other assets is then distributed to the original corporation's stockholders. See, for example, Becher v. Commissioner, 221 F.2d 252 (2 Cir. 1955); Lewis v. Commissioner, 176 F.2d 646 (1 Cir. 1949). 2. The stockholders form a new corporation to which the old corporation then sells its property, followed by the liquidation of the old corporation. See, for example, Liddon v. Commissioner, 230 F.2d 304 (6 Cir. 1956), **cert. den.**, 352 U.S. 824 (1956); Pebble Springs Distilling Co., 23 T.C. 196 (1954), **aff'd**, 231 F.2d 288 (7 Cir. 1956), **cert. den.**, 352 U.S. 836 (1956). 3. The old corporation can first be liquidated, followed by the stockholders transferring the assets to a new corporation. See, for example, Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2 Cir. 1954), **cert. den.**, 349 U.S. 906 (1955); Survant v. Commissioner, 162 F.2d 753 (8 Cir. 1947).

most common form of the problem does not mean that it had any intention of allowing the two evils most inherent in a reorganization scheme to persist. *Cf. Johnson v. United States*, 163 Fed. 30, 32 (1 Cir. 1908) (Opinion by Mr. Justice Holmes).

Moreover, since the operative sections were cast in terms of stock transfers, it was only normal that in referring to those sections in 368 (a) (1) (D) that Congress referred to "stock or securities" "distributed in a transaction which qualifies under section 354, 355, or 356." Congress thus did not intend to place any special emphasis on the idea that stock *must* be transferred, rather Congress only intended to use this convenient terminology in referring to the operating provisions of the Code.[25]

Petitioners' major argument against the application of 368 (a) (1) (D) and 354, 356 thus rests on the weak foundation that Congress required stock to pass before a reorganization under section 368 (a) (1) (D) could be found. Section 354 when coupled with section 356 requires that cash or liquid assets received by stockholders as part of a reorganization be taxed as a dividend. In *Commissioner v. Morgan*, 288 F.2d 676 (3 Cir. 1966), the taxpayer also claimed that Congress' clear intent could be avoided by a transaction where no new stock passed.

In *Morgan*, taxpayer was the sole stockholder of two corporations. They, like the corporations here involved, had been in operation for many years. In overruling the taxpayer's objections, the Third Circuit said (288 F.2d at 680):

25. In fact, a study of the complete legislative history of section 368(a)(1)(D) clearly shows that when Congress added the second section in 1954, it was attempting to close old loopholes, not create new ones.

> "If the transferor's assets had been transferred to a newly formed corporation in exchange for stock, there is no question that the boot [cash or liquid assets received] would have been taxable as dividend income. That an existing corporation in which the taxpayer was the sole shareholder was used instead of a newly formed one cannot alter the true nature of the transaction. Here, the issuance of new stock would have been a meaningless gesture since the stock the taxpayer already held represented the total value of all the assets except for the boot."

Applying the rationale of *Morgan* to the instant case requires the same result. The same stockholders owned all of the stock of both Water and Warehouse. Before the transaction the operating assets' value of Warehouse was reflected in the value of its stock. Similarly, the operating assets' value of Water was reflected in the value of its stock. The stockholders had both stocks and their combined certificates reflected the value of their combined operating assets. After the transaction petitioners only had the stock of Water, but it then reflected the value of the combined operating assets of Water and Warehouse. Therefore, the appreciation of the value of Water's stock certificates caused by the transfer of Warehouse's operating assets to Water was the equivalent of issuing $700,000 worth of new or additional stock to Water's stockholders.[26] "*Here*,

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26. It follows logically from what we have said that the basis formerly belonging to petitioners' Warehouse stock must now be added to the basis of their Water stock. Had the assets of Warehouse been transferred to Water for Water's stock, as they would have been if this transaction had actually been cast as a reorganization, the Water stock would have received the basis of petitioners' Warehouse stock when Warehouse was liquidated. See Treasury Reg. 1.358-1. A different result should not be obtained just because petitioners received no new stock but merely allowed their existing stock to appreciate in value. Cf. Treasury Reg. 1.302-2(c).

*the issuance of new stock would have been a meaningless gesture * * *." Commissioner v. Morgan, supra; accord, Liddon v. Commissioner,* 230 F.2d 304 (6 Cir. 1956), *cert.den.,* 352 U.S. 824 (1956). To require the actual transfer of stock certificates where such a transfer would be a meaningless gesture would be to make the reorganization provisions optional with the taxpayer, a result which Congress clearly did not intend.

Conversely, a purchase of stock has been treated as a purchase of assets where it is necessary to effectuate the intent of the Code. Take, for example, the situation where a taxpayer purchases all of the stock in a corporation solely so he can liquidate the corporation and use the assets. Application of section 331 would distort the reality of what has taken place. In such situations the courts have treated the purchase of stock as if it were a purchase of assets. *Snively v. Commissioner,* 19 T.C. 850 (1953), *aff'd,* 219 F.2d 266 (5 Cir. 1955); see also *Western Wine & Liquor Co. v. Commissioner,* 18 TC 1090 (1952); *Cullen v. Commissioner,* 14 T.C. 368 (1950). Neither the appreciation or depreciation of the assets between the time the stock was purchased and the corporation liquidated will be recognized by the taxpayer. Therefore, we see that the treatment of stock as assets, or assets as stock, has always been utilized by the courts in harmonizing the statutory language with the single rational plane of taxation envisioned by Congress.[27]

27. Petitioners have cited us to a number of cases where the courts have construed the reorganization provisions with strict literalness without regard to the fact that it defeated the purpose of the tax statute. Each time, Congress acted to close the judicially created loophole. From this interchange of events, petitioner asks us to draw the conclusion that the courts should always permit tax evasion when a literal application of the Code will minimize tax consequences regardless

We come now to the last leg of our journey; the question of whether the earnings and profits of Warehouse and Water should be combined in determining whether the full $900,000 cash received by petitioners should be treated as a dividend. We hold that the $700,000 coming indirectly from Water and the $200,000 coming from Warehouse must be tested against their combined earnings and profits. Whether we reach this result by means of calling this transaction a type (E) or type (F) reorganization, or a dividend declared simultaneously with a reorganization, makes no difference. But, in order to avoid future confusion, we think it appropriate to explain our three separate rationales.

Taking in inverse order the separate methods of reaching our conclusion, we hold that the $700,000 petitioners received from Water and the $200,000 petitioners received

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of the true economic realities. We draw just the opposite conclusion. Having been consistently rebuked by Congress in this area whenever we departed from the inherent purpose of the statutory scheme, we should avoid making the same mistakes and, instead, utilize all our efforts to apply the Code as Congress intended. The problem created for Congress if the courts adopt any other approach to the reorganization provisions is made painfully apparent by this litigation. The statute must be narrow enough to prevent sales being made to look like reorganizations and broad enough to prevent reorganizations being made to look like sales. Had the courts adhered to obvious legislative intent and not felt restricted to a literal and rather restrained interpretation, there would have been no necessity for Congress to enact the detailed, almost impossible to follow, complicated reorganization provisions which now confront us. The rules could be simple: 1) those who genuinely participate in reorganizations would get the tax defendant Congress intended; 2) those who sell property or withdraw earnings would be taxed as Congress intended. The considerations underlying the reorganization provisions were not cast in terms of form but of substance. Courts in performing their judicial duty must take notice of this fact. See Bazley v. Commissioner, 331 U.S. 737 (1947).

from Warehouse were dividends under section 301, declared incident to a reorganization. See *Bazley v. Commissioner*, 331 U.S. 737 (1947). In *Bazley*, a corporation attempted to transfer liquid assets to a taxpayer claiming they were a part of a reorganization under what is now section 368 (a) (1) (E) which provides for recapitalizations. The Supreme Court characterized the modification of the capital account which constituted the reorganization-recapitalization as "unrelated" to the transfer of the liquid assets which the Court held to be a dividend under what is now section 301.

The same characterization is apt in the instant case. Three separate events took place. The distribution of $700,000 which had been generated incident to the earnings and profits of Water has no rational connection with the reorganization involving Warehouse. It was not necessary to pass this money through Warehouse and Bruce, Jr. in order to accomplish the reorganization. Everything that we said about Bruce, Jr. may be said about Warehouse in regard to the $700,000. Warehouse, under the circumstances of this case, was in no real sense a seller of assets to Water but merely a conduit through which funds passed from Water to Water's stockholders. Since both Warehouse and Water were owned in exactly the same way by the same stockholders, after the funds ended their circuitous route through Warehouse and Bruce, Jr., we see that they were a distribution "with respect to its stock" as required by section 301. The effect was precisely the same as if Water had passed them up directly to its stockholders.

The fact that we held that the transfer of Warehouse's assets and the "sale"-liquidation of Warehouse's stock should be viewed as an integrated transaction does not mean that we are being inconsistent when we separate

the distribution of Water's cash to its stockholders. We are merely recognizing that two distinct and functionally unrelated types of transactions were carried on simultaneously—one was a dividend and the other a reorganization. The Code does the same thing in section 356. It recognizes that a series of complicated events may occur which are legitimately a reorganization. These are not taxed. Simultaneously, a taxpayer may receive boot having the effect of a dividend. The dividend's only relation to the reorganization is that it occurred at the same time. The boot where appropriate is taxed as a dividend.

Water, if it chose, could have declared the $700,000 as a dividend before the reorganization with Warehouse ever took place. Or Water could have waited and a week, a month or a year later distributed this dividend. Had it chosen any of these courses, the reorganization involving Warehouse would not have been affected in the slightest. We, therefore, hold that the $700,000 received by petitioners from Water is a distribution governed by sections 301(a), 301(c) and 316. The same reasoning demonstrates that $200,000 coming from Warehouse was a dividend since it was functionally unrelated to the reorganization.[28]

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28. Since Warehouse ceased to exist after the reorganization, it obviously could not have declared a $200,000 dividend after the reorganization. But after the reorganization, if the $200,000 had not been declared as a dividend before, it would have passed to Water along with all of Warehouse's statutorily attributable earnings and profits under section 381. Section 381 was enacted in 1954 to provide a comprehensive set of rules for the preservation of merging corporations' tax attributes, such as earnings and profits. This preservation was to be "based upon economic realities rather than upon such artificialities as the legal form of the reorganization." S.Rep. No. 1622, 83 Cong., 2d sess., 52. Therefore, if Water had distributed the $200,000 received from Warehouse after the reorganization it would have been a dividend under 301(a), 301(c), 316.

We, therefore, hold that the $200,000 received by petitioner from Warehouse is a distribution governed by section 301(a), 301(c) and 316.

Even if the $700,000 received from Water were not a dividend under sections 301(c) and 316, it would be boot under section 356. Section 356 tells us that, when a taxpayer as part of a reorganization receives not only stock but liquid assets or cash to boot, that boot shall be taxed as a dividend to the extent of the earnings and profits of the distributing corporation. The Tax Court believed the words "of the corporation" referred only to Warehouse and, therefore, held that the $900,000 received should be taxed only to the extent of Warehouse's earnings and profits since it was the only distributing corporation.

We cannot agree with this narrow construction in a case where there is complete identity of ownership of both corporations. Water and Warehouse were but different pockets in the same pair of trousers worn by petitioners. It would be illogical to say that $700,000 would be used to measure how much of the $900,000 distribution had the effect of a dividend if Water were merged into Warehouse and only $200,000 should be used to measure how much of the $900,000 distribution had the effect of a dividend just because Warehouse was merged into Water.

Where there is complete identity of stockholders, the use of the earnings and profits of both corporations is the only logical way to test which distributions have the effect of a dividend. Before the reorganization the petitioners had two pockets with $900,000 in cash divided between them. After the reorganization the petitioners had removed all that cash from both pockets, and it should not matter that before removing it completely they took it out of the right pocket and put it in the left.

The statute in speaking of "the corporation" means the corporation controlled by the stockholders receiving the distribution. Where there is complete identity, as here, the stockholders control both corporations and it is virtually impossible to tell which corporation is in reality "the corporation" distributing the cash. We have two corporations each one of which is distributing cash; therefore, we must look at the earnings and profits of both corporations to see if the distribution is essentially equivalent to a dividend or has the effect of a dividend.

The Tax Court was correct that section 356(a)(2) in using the term "the corporation" meant the distributing corporation. However, the Tax Court erred when it failed to see that in this case there were two distributing corporations, each of which was a party to this reorganization. As we said in connection with our holding for purposes of applying section 301, Warehouse was a conduit for Water's distribution of $700,000 and thus, in determining which corporation was the distributing corporation for purposes of 356 (a)(2), we look through Warehouse and reach Water. *Cf. Commissioner v. Owens*, 69 F.2d 597 (5 Cir. 1934); also compare *United States v. Joliet & Chicago R. Co.*, 315 U.S. 44 (1942).

It would not benefit petitioners even if they prevailed on their argument that "the corporation" means only the last distributing corporation. Section 482 permits the Commissioner to "allocate" such tax attributes as are here involved between two corporations "owned" "by the same interests" if "such" "allocation is necessary in order to prevent evasion of taxes." No clearer evasion of taxes can be imagined than converting what would be a dividend taxable at ordinary rates into a capital gain by merely passing it through another corporate shell. We hold that under sec-

tion 356 and/or section 482 the effect of distributing the $700,000 and the $200,000 must be tested by the combined earnings and profits of both Warehouse and Water.

We need pause for only a moment at the door of 368 (a) (1) (F). The effect of a type (F) reorganization is largely uncharted ground; we hold that the funds passed to stockholders in a type (F) reorganization must be tested by the standards laid down under sections 301 and 316. As we showed earlier, that would result in the $900,000 being tested by the earnings and profits of both Warehouse and Water.

Since the Tax Court did not find what Water's earnings and profits were at the time relevant for determining the effect of its distribution of $700,000, we must remand this case. The opinion of the Tax Court is affirmed in part and reversed in part, and the case is remanded for further proceedings not inconsistent with this opinion.

AFFIRMED IN PART AND REVERSED IN PART.

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1965

NO. 22,835

D. C. Docket Nos. 1114-63 thru 1123-63;
2460-63; 5611-63

J. E. DAVANT and KATHRYN DAVANT, ET AL.,
Petitioners-Respondents,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Petitioner.

(AND REVERSE TITLE)

Petitions for Review of Decisions of the Tax Court of the United States (Texas Case)

Before RIVES and BELL, Circuit Judges, and FULTON, District Judge.

JUDGMENT

This cause came on to be heard on the petitions of J. E. Davant and Kathryn Davant, et al. for review of decisions of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decisions of the Tax Court in this cause be, and the same are hereby affirmed in part and reversed in part, and that this cause be, and the same is hereby remanded to the said Tax Court for further proceedings not inconsistent with the opinion of this Court.

August 22, 1966

Issued as Mandate:

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

NO. 22,835

J. E. DAVANT and KATHRYN DAVANT, ET AL.,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petitions for Review of Decisions of the Tax Court of the United States (Texas Case)

(October 4, 1966).

ON PETITION FOR REHEARING

Before RIVES and BELL, Circuit Judges, and FULTON, District Judge.

PER CURIAM:

The petition for rehearing filed by the petitioners in this case is hereby DENIED.

APPENDIX B

STATUTES INVOLVED

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * *

(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—

(1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) REDEMPTIONS TREATED AS EXCHANGES.—

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) TREATMENT OF CERTAIN STOCK PURCHASES.—

(1) ACQUISITION BY RELATED CORPORATION (OTHER THAN SUBSIDIARY).—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

(2) ACQUISITION BY SUBSIDIARY. — For purposes of sections 302 and 303, if—

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation,

then such property shall be treated as a distribution in redemption of the stock of the issuing corportion.

SEC. 316. DIVIDEND DEFINED.

(a) GENERAL RULE.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) GENERAL RULE.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be

recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) GAIN ON EXCHANGES.—

(1) RECOGNITION OF GAIN.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) ADDITIONAL CONSIDERATION RECEIVED IN CERTAIN DISTRIBUTIONS.—If—

(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of part I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

SEC. 1201. ALTERNATIVE TAX.

* * *

(b) OTHER TAXPAYERS.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

APPENDIX C

HISTORY OF DEFINITION OF REORGANIZATION

The Revenue Act of 1918 simply had Sec. 202(b) as follows:

"SEC. 202. (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged."

The Revenue Act of 1921 had Sec. 202(c)(2) as follows:

"Sec. 202. (c) (2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word 'reorganization,' as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected);"

The Revenue Act of 1924 had Sec. 203(h):

"SEC. 203 (h) As used in this section and sections 201 and 204—

"(1) The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected."

The Revenue Act of 1934 had Sec. 112(g)(1):

"SEC. 112. (g) (1) The term 'reorganization means (A) a statutory merger or consolidation, or

(B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place or organization, however effected."

Sec. 112(g) of the Internal Revenue Code of 1939 was exactly the same as the same section in the 1936 Revenue Act.

Sec. 368(a)(1) of the Internal Revenue Code of 1954 was as follows:

"SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term 'reorganization' means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded.

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected."